No. 7892

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELLIOTT PETROLEUM CORPORATION, RESPONDENT

ON PETITION FOR REVIEW OF DECISIONS OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

FRANK J. WIDEMAN,
Assistant Attorney General.
SEWALL KEY,
HELEN R. CARLOSS,
Special Assistants to the Attorney General.

INDEX

CITATIONS

34061—35——1

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 7892

Commissioner of Internal Revenue, petitioner

v.

Elliott Petroleum Corporation, respondent

ON PETITION FOR REVIEW OF DECISIONS OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

OPINION BELOW

The only previous opinion in this case is that of the Board of Tax Appeals (R. 52–56), which is unreported.

JURISDICTION

The appeal involves a deficiency in income tax for the year 1930, in the amount of $1,045.29, and is taken from a decision of the Board of Tax Appeals, entered January 3, 1935 (R. 57). The case is brought to this Court by petition for review filed March 19, 1935 (R. 58–63), pursuant to the provisions of Sections 1001–1003 of the Revenue Act of

1932, as amended by Section 1001 of the Revenue Act of 1932, c. 209, 47 Stat. 169, and by Section 519 of the Revenue Act of 1934, c. 277, 48 Stat. 680.

QUESTION PRESENTED

The taxpayer sold and assigned an oil and gas lease which it acquired from the lessees of the property, together with certain drilling equipment and personal property, for the flat sum of $275,000, of which $137,500 was to be paid in cash and $137,500 was to be paid " out of one-half of the net proceeds of all production from the demised premises ", with the proviso that if the assignee should surrender the lease or default, then the latter sum should immediately become due and payable and should become the personal and direct obligation of the assignee. The question is whether the taxpayer is entitled to the percentage depletion allowance of 27½ percent with respect to a deferred payment of $69,699.81, received in 1930.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra,* pp. 20–26.

STATEMENT

The following facts are taken from the Board's memorandum opinion and from the documentary evidence which were incorporated in the Board's memorandum opinion by reference.

The taxpayer is a corporation, having its principal place of business in Los Angeles, California, and it filed its return for 1930 in the Sixth Collection District of California (R. 52).

On June 13, 1922, J. E. Elliott secured an oil and gas lease of certain land in Los Angeles County from Chauncey Dwight Clarke and Marie Rankin Clarke, for a period of 20 years (R. 12–34, 52). The lessee agreed to drill a well of a certain character before August 1922 (R. 15). The lessee agreed to pay the lessors $8,000 in cash for the right to drill, to pay $16,000 out of oil and gas produced, together with 30 percent of the oil and gas produced, either in kind or in cash, after the allowance of certain expenditures; and if casing head gas should be produced, 30 percent of the prevailing market price therefor at the well less cost of manufacture (R. 17–20).

The lease was subject to cancellation if oil or gas was not produced in paying quantities, or for default (R. 16, 29). The lessee also agreed to pay certain taxes and assessments (R. 21–22), and there are other provisions which are not very material to this controversy.

On June 27, 1922, Elliott and his wife sold and assigned this lease to the Elliott Petroleum Corporation, the taxpayer, for "a valuable consideration", the nature of which was not described in the assignment (R. 34–36).

On August 17, 1928, the taxpayer in turn sold and assigned the lease to the Richfield Oil Company of California, for a "consideration of $1.00 and other consideration" (R. 36–39). This assignment was approved by the lessors, subject to certain conditions, which were accepted by the assignee (R. 39–42).

On the same day (August 17, 1928), by bill of sale, the taxpayer sold to the Richfield Oil Company all the personal property and equipment on the lease "in consideration of the sum of Ten Dollars ($10.00) lawful money of the United States" (R. 43–44). A list of these assets was included in the bill of sale (R. 44–45).

Also on the same day, a collateral agreement referring both to the assignment of the lease and the bill of sale was executed by the taxpayer and the Richfield Oil Company (R. 46–51).

This agreement provided that the assignee would drill a new well, would perform a certain contract with the Pacific Gasoline Company and that it would pay $275,000 in consideration of the assignment of the lease and bill of sale, of which $137,500 was to be paid in cash (R. 47–48).

This collateral agreement provided further (R. 49–50):

> SIXTH: It is agreed that second party shall pay the balance of the purchase price above referred to amounting to $137,500.00, out of one half of the net proceeds of all production from the demised premises. The term "net" as here used, shall apply to and be deemed to be the proceeds of all of the gross production of oil gas or other substances of value produced and saved after deducting

therefrom the royalties provided for in the above lease or the modification thereof, hereinbefore referred to, and the amount thereof as fuel as provided in said lease and/or said modification.

Payments on account of the balance of the purchase price, statements affecting the same and rights of inspection shall be as are provided for in the lease above refered to and be governed by the rules and obligations therein specified as such lease now exists, and/or as the same shall exist under said modification, respecting the payment of royalty under said lease, as to time, diligence, and procedure.

The price, however, governing the payments to first party for the balance of the purchase price of oil and/or gas, shall be the price as to oil which the Lessee therein named, shall pay to the Lessor therein named (in the event that the Lessor shall elect to take royalties in cash or enter into a joint contract for the sale of oil) or the posted price of the Standard Oil Company for said Sante Fe Springs field for oil of like grade and quality, whichever shall be greater.

Seventh: Should the second party voluntarily surrender said lease, while and so long as said lease produces oil or gas or other of said substances in quantities sufficient to produce or save, or should the leasehold estate be lost by reason of the default of the party of the second part, or should the party

> of the second part remain in default for the period of fifteen days in the performance of any other of the terms or conditions of this agreement, direct or adopted, after written demand for such performance, then the balance of the purchase price shall become immediately due and payable and the same shall constitute a personal and direct obligation of the party of the second part to the party of the first part, anything in this instrument to the contrary notwithstanding.
>
> * * * * *

In 1928, the taxpayer received from the Richfield Oil Company the cash consideration of $137,500 mentioned in the agreement, plus $19,494.58 on account of the deferred payment, or a total of $156,994.58. In 1929, it received $35,797.68, and in 1930, $69,699.81 (R. 55).

In 1928 the Commissioner determined that the taxpayer realized a profit from the sale of its lease, measured by the difference between the sum of $156,994.58 received in that year and the sum of $38,272.53, representing its unrecovered capital cost of the lease and advised the taxpayer that subsequent payments would be taxed in full (R. 7). He disallowed the depletion claimed in 1930, equal to 27½ percent of the deferred payment of $69,699.81 received in that year, and determined a deficiency of $1,045.29 (R. 8, 55).

Upon appeal, the Board overruled the Commissioner's determination, holding that there was no deficiency.

SPECIFICATION OF ERRORS TO BE URGED

We urge that the Board erred:

1. In holding that the amount of $69,699.81, received by the taxpayer in 1930, out of the proceeds of oil production in part payment for the assignment of the lease and for the personal property and equipment is subject to depletion.

2. In holding that the taxpayer was entitled to a deduction for depletion of 27½ percent of $69,699.81.

3. In failing to approve the deficiency determined by the Commissioner.

4. In not rendering judgment for the Commissioner for the reason that any other judgment was not supported by any competent and substantial evidence, nor according to law.

SUMMARY OF ARGUMENT

Section 114 (b) (3) of the Revenue Act of 1928, *infra,* provides that the allowance for depletion in the case of oil and gas wells shall be 27½ percent of the "gross income from the property during the taxable year", but that it shall not exceed 50 percent of the net income of the taxpayer from the property and shall not be less than the allowance would be if computed without reference to that paragraph.

It is well settled that the phrase "gross income from the property" means gross income from the wells and that when the allowance is determined it must, in the case of a lease, be divided equitably between the lessor and the lessee.

In this case the taxpayer parted with all of its right, title, and interest in an oil and gas lease and as part of the same agreement sold its personal property on the lease for a total consideration of $275,000, one-half to be paid in cash and one-half "out of the net proceeds of all production from the demised premises."

The payment of $69,699.81 received during 1930 was a deferred payment under the clause just quoted.

It is our position that the taxpayer retained no royalty or other economic interest in the oil and gas in place and is not entitled to a depletion allowance.

While the Supreme Court has held that the statutes authorizing depletion deductions are broad enough to allow a deduction for depletion in every case in which the taxpayer has retained an economic interest (as distinguished from a purely legal interest) in the oil and gas in place, it has held that one must have an economic interest in the oil and gas to be entitled to depletion.

In this case the taxpayer did not retain any right to share in the oil produced and had no interest in the oil in place. It sold its entire interest in the oil and gas for a cash payment and an additional sum which was to be paid from *net proceeds* of the sale of oil, if oil was produced and sold. This was not a royalty interest or any economic interest in the oil and gas in place.

To hold otherwise would be contrary to the whole theory of depletion as the allowance of a loss realized through the exhaustion of the product. This taxpayer suffers no loss through the exhaustion of oil and gas through production. It is entitled to a fixed sum which is payable if the oil and gas is produced. Extraction does not reduce the amount. The loss in question falls upon the assignee.

By the very terms of the statute here involved the depletion allowance cannot be computed with reference to net proceeds of the sale of oil and gas. The deduction allowed is a percentage of gross income from the well.

If the taxpayer were allowed the depletion claimed, the amount allowed would have to be deducted from the depletion allowed the assignee and the lessor. Yet they are the only ones who are gradually losing their capital as the well is exhausted.

ARGUMENT

The taxpayer had no royalty or other economic interest in the oil and gas in place and is not entitled to an allowance for depletion based on deferred cash payments received for the assignment of its lease and the sale of the personal property situated thereon

Section 23 (1) of the Revenue Act of 1928, *infra,* provides for the deduction of a reasonable allowance for depletion of oil and gas wells which, in the case of leases, is to be equitably apportioned between the lessor and lessee. Section 114 (b) (3), *infra,* provides that the allowance shall be "27½ percent of the gross income from the property during the taxable year", but that it shall not exceed 50 percent of the net income of the taxpayer from the property and shall not be less than the allowance would be if computed without reference to that paragraph.

It is well settled that the phrase "gross income from the property" means gross income from the wells. *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312; *Greensboro Gas Co.* v. *Commissioner* (C. C. A. 3d), decided September 18, 1935, not officially reported but found in 1935 C. C. H., Vol. 3–A, p. 10429; *Consumers Natural Gas Co.* v. *Commissioner,* 78 F. (2d) 161 (C. C. A. 2d); *Darby-Lynde Co.* v. *Alexander,* 51 F. (2d) 56 (C. C. A. 10th), certiorari denied, 284 U. S. 666. See also *Brea Cannon Oil Co.* v. *Commissioner,* 77 F. (2d) 67 (C. C. A. 9th); *Macon Oil & Gas Co.* v. *Commissioner,* 23 B. T. A. 54; *Fritz* v. *Commissioner,* 28 B. T. A. 408. Moreover, when the allowance is determined it must, in the case of a lease, be divided equitably between the lessor and the lessee. *Helvering* v. *Twin Bell Syndicate, supra.*

In the instant case the taxpayer parted with all of its right, title, and interest in the oil and gas lease and as part of the same agreement, sold its personal property for a total consideration of $275,000, one-half to be paid in cash at once and the balance to be paid " out of one-half of the net proceeds of all production from the demised premises."

During the year 1930, the taxable year here involved, the taxpayer received a cash payment of $69,699.81 as a deferred payment under the clause just quoted, and the Board held that under Section 114 (b) (3), *infra,* it was entitled to a depletion allowance equal to 27½ percent of that amount.

We submit that the taxpayer retained no royalty or other economic interest in the oil in place and that the Board clearly erred in holding that an assignor of a lease so situated is entitled to a depletion allowance under Section 114 (b) (3), *infra.*

In holding otherwise, the Board relied upon its prior decision in *Jones* v. *Commissioner,* 31 B. T. A. 55, now pending on appeal before the Circuit Court of Appeals for the Fifth Circuit, and in its decision in that case it relied upon the decision of the Supreme Court in *Palmer* v. *Bender,* 287 U. S. 551.

The *Palmer* case arose under an earlier statute which did not provide for percentage depletion deduction and involved the question whether two lessees who transferred their operating rights to two oil companies for a present payment in cash, a payment of $1,000,000 "out of one-half of the first oil produced and saved" and an additional "excess royalty" of one-eighth of all the oil produced and saved was entitled to a deduction for depletion. The Government argued that the owners of the leases sold and assigned them instead of executing subleases and hence that they had retained no legal interest in the mineral property which entitled them to a depletion allowance. The Supreme Court rejected that argument, holding that it was immaterial whether the transactions effected sales or subleases and that the language of the statutes was broad enough to allow a deduction for depletion in every case in which the taxpayer had secured an economic interest (as distinguished from a purely legal interest) in the oil and gas in place, and retained such an interest upon transfer or assignment of the leasehold to another.

That the Supreme Court insisted upon the retention of an economic interest in the property by the transferors and that it relied upon the reservation of royalty as establishing such interest in that case is clear. The Court said in part (pp. 557–558):

> Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. Thus, we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease. See *Burnet*

v. *Harmel, supra; Bankers Pocahontas Coal Co.* v. *Burnet, ante* p. 308.

In the present case the two partnerships acquired, by the leases to them, complete legal control of the oil in place. Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute. *Lynch* v. *Alworth-Stephens Co., supra.* When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor. *Burnet* v. *Harmel, supra; Bankers Pocahontas Coal Co.* v. *Burnet, supra.* Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case

> of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case.

The taxpayer in this case did not retain any right to share in the oil produced and had no interest in the oil in place, so that it is not entitled to a depletion allowance under the rule laid down in *Palmer* v. *Bender, supra.*

The taxpayer did not reserve any overriding royalty as was the case there. The right to a payment of the second half of the $275,000, out of one-half of the *net proceeds* of all production from the demised premises, was not a royalty within the usual definition of the term, as a share in the oil produced. *Bellport* v. *Harrison,* 123 Kan. 310; *Leydig* v. *Commissioner,* 43 F. (2d) 494 (C. C. A. 10th); Thornton, Oil and Gas, 5th Ed., Vol. 2, pp. 644–645. A royalty reserved by an assignee of a lessee is usually termed an overriding royalty. In Mills and Willingham's Law on Oil and Gas, p. 184, the term "overriding royalty" is defined as follows:

> An "overriding royalty" is a given percentage of the gross production payable to some person other than the lessor or persons claiming under him. It occurs where some owner of a working interest contracts to deliver a part of the gross production to another, usually his assignor. Such contracts are most frequently found as a reservation in an assignment of a lease. The provision creates in the owner of such royalty an interest in the lease, cannot be transferred or surrendered except with the same formali-

ties necessary for a transfer of the lease, and is binding upon subsequent assignees of the lease, except innocent purchasers.

See also *Comar Oil Co.* v. *Burnet,* 64 F. (2d) 965 (C. C. A. 8th), certiorari denied, 290 U. S. 652.

The taxpayer in this case did not retain any interest in production. It was only in the event that oil was produced and *sold* that it would receive any additional sum by way of consideration for the sale of the lease above that which was paid in cash at the time that the transfer was made. The additional sum, moreover, was to be paid only out of the net proceeds of the sale. There was not even a lien on production for the payment of the amount.

We believe that the case is no different from what it would be if the entire sum of $275,000 had been paid on the transfer. In *Darby-Lynde Co.* v. *Alexander, supra,* the taxpayer who had made a sale of oil property during the taxable year for a single cash payment argued that he should be allowed to deduct 27½ percent of the amount received as a deduction for depletion under Section 204 (c) (2) of the Revenue Act of 1926, which is identical with Section 114 (b) (3) of the Revenue Act of 1928, here involved. The Court rejected that argument, holding that the phrase "gross income from the property" meant gross income from production.

The same conclusion was reached in *Pugh* v. *Commissioner,* 49 F. (2d) 76 (C. C. A. 5th), certiorari denied, 284 U. S. 642, where the taxpayer assigned one-half of his royalty interest for a consideration of $250,000, of which $50,000 was payable at once and $200,000 out of future production of oil. That case, however, is perhaps weaker than the instant case, because there the taxpayer did not sell his entire royalty interest.

That the deferred payment in this case was not a reserved royalty is also supported by *Comar Oil Co.* v. *Burnet, supra,* although that case did not involve a question of depletion. In that case the taxpayer secured a lease of certain oil land for a consideration of $50,000 in cash and $100,000 to be paid out of one-eighth of the gross production of oil and gas, a second lease for which $100,000 was payable in cash and the balance out of one-half of the oil produced, and a third lease for a consideration of $3,000,000, of which $1,750,000 was payable in cash and the balance out of one-half of the oil produced. The taxpayer claimed the right to deduct the payments made out of oil under these leases as deductions from gross income on the ground that they were royalties. The Court held that the payments were not royalties but capital expenditures made in connection with the acquisition of capital assets.

Attention is called to the fact that certiorari was denied in that case after the decision in *Palmer* v. *Bender, supra.*

If the payments made by the assignee in that case were not royalties but capital expenditures, then to the assignor they constituted receipts from the sale of property and not royalties. Much less were the deferred payments royalties in this case, where they were to be paid out of the net proceeds from production.

We think it clear that the deferred payments cannot be assimilated to a bonus which is in the nature of an advance payment of royalties reserved for oil to be extracted normally and involves a return of the taxpayer's investment in the oil in place. *Burnet* v. *Harmel,* 287 U. S. 103; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. Hence the fact that depletion is allowed with respect to a bonus (*Herring* v. *Commissioner,* 293 U. S. 322), furnishes no justification for allowing the selling price of an outright disposition of oil property, without reservation of a royalty or other economic interest in the oil itself, to form the basis of a depletion allowance.

To hold otherwise is contrary to the reasoning of the Court in *Palmer* v. *Bender, supra,* and contrary to the whole theory of depletion as the allowance of a loss realized through the exhaustion of the product.

This taxpayer suffers no loss through the exhaustion of oil and gas through production. Under its contract it might have failed to receive income it expected to receive because the mineral content was not there at all. But extraction would not cause a gradual reduction in the amount it was entitled to receive out of that production.

The fundamental purpose of the depletion statutes, both before and subsequent to the enactment of the percentage depletion provisions has been to return to the taxpayer a reasonable allowance for the exhaustion of his interest in the property caused by the depletion of his natural resource during the taxable year. *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364; *Palmer* v. *Bender, supra; Night Hawk Leasing Co.* v. *Burnet,* 57 F. (2d) 612 (App. D. C.); *Greensboro Gas Co.* v. *Commissioner, supra.*

We submit that the loss in this case falls on the assignee who is operating the property and is entitled to the gross income from production, except insofar as it is divided with the owner (lessor). It should be remembered that only one allowance is granted. Where the operator pays a royalty to one retaining an economic interest, he and the recipient of the royalty together can claim a deduction equal to 27½ percent of the gross income from the well. *Helvering* v. *Twin Bell Syndicate, supra.*

Not only is one having no economic interest in the oil and gas in place not entitled to depletion, but under the very terms of the statute here involved the depletion allowance cannot be computed where the interest is a certain sum to be paid out of *net proceeds* from production and sale of oil. The deduction is based on the gross income from the well.

For that reason, it has been held that where some manufacturing process, or other service, is performed by one having an interest in production, before the product of the well is sold, the depletion allowance must be based on the market value of the product at the mouth of the well. *Brea Cannon Oil Co.* v. *Commissioner, supra; Consumers Natural Gas Co.* v. *Commissioner, supra; Greensboro Gas Co.* v. *Commissioner, supra; Signal Gasoline Corp.* v. *Commissioner,* 66 F. (2d) 886, 77 F. (2d) 728 (C. C. A. 9th).

This taxpayer is seeking to claim a deduction not based on gross income from the well, but on a deferred, fixed payment for the property, made out of the net proceeds of the sale of the product. The assignee could claim no deduction for the payment as royalties under the *Comar* case, *supra,* but if the taxpayer is allowed a deduction for depletion based on it, the assignee must reduce the gross income from the property by that amount and will get only 27½ percent of the difference as his allowance for depletion. Yet, it is the assignee and the lessor who suffer a diminution in their future income through extraction.

CONCLUSION

The decision of the Board of Tax Appeals should be reversed.

Respectfully submitted,

Frank J. Wideman,
Assistant Attorney General.

Sewall Key,
Helen R. Carloss,
Special Assistants to the Attorney General.

December 1935.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

*   *   *   *   *

(1) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

*   *   *   *   *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

*   *   *   *   *

(b) *Basis for depletion.*—

(1) *General rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property, except as provided in paragraphs (2) and (3) of this subsection.

(2) *Discovery value in case of mines.*—In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per

centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 221. *Depletion of mines, oil and gas wells; depreciation of improvements.*

* * * * *

(i) "Depletion allowance based on the income from oil and gas wells": The deduction for depletion based on the income from oil and gas wells shall not exceed 50 per cent of the net income of the taxpayer, computed, without allowance for depletion, from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to the income from the property. The phrase "net income of the taxpayer (computed without allowance for depletion)" means the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, development expenses (if the taxpayer has elected to deduct development expenses), depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. If the oil and gas are not sold on the property but are manufactured or converted into a refined product or are transported from the property prior to sale, then the gross income shall be assumed to be equivalent to the market or field price of the oil and gas before conversion or transportation. Depreciation, taxes, and such expenses as overhead (which cannot be directly attributed to any particular property) shall be allocated on the basis of the ratio of the number of units produced from the property on which depletion is claimed to the total number of units produced from the operating division in which the property is located. In cases where the taxpayer, in addition to producing oil and gas, engages in additional activities such as operating refineries and transportation lines, depreciation, taxes, and such expenses as overhead which cannot be directly attributed to any specific activity, shall be allocated to the production of oil and gas on the basis of the ratio which the operating expenses and development expenses (if the taxpayer has elected to deduct development expenses) directly attributable to the production of oil and gas bear to the taxpayer's total operating expenses and development expenses.

ART. 235. *Computation of depletion allowance not based on the income from the property in the case of combined holdings of oil and gas wells.*—The recoverable oil belonging to the taxpayer shall be estimated for each property separately. The unit value of the recoverable oil and/or gas for each property is the quotient obtained by dividing the amount returnable through depletion for each property by the estimated number of units of recoverable oil and/or gas on that property. This unit for each separate property multiplied by the number of units of oil and/or gas produced by the taxpayer upon such property and sold within the year will determine the amount which may be deducted for depletion from the gross income of that year for that property. The total allowance for depletion of all the oil and/or gas properties of the taxpayer will be the sum of the amounts computed for each property separately. However, in the case of gas properties the depletion sustained for each pool may be computed by using the total amount returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool. The total allowance for depletion in the gas properties of the taxpayer will be the sum of the amounts computed for each pool. If, however, the deduction is computed on the basis of the income from the property under section 114 (b) (3), see article 241.

Art. 236. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which sum payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(d) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ percent of the amount thereof, but the deduction shall not exceed 50 percent of the net income (computed without allowance for depletion) from the property.

ART. 241. *Depletion in the case of oil and gas wells.*—Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (See article 221 (i).) In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, "the property", as the term is used in section 114 (b) (3) and this article, refers to the separate tracts or leases of the taxpayer.

U. S. GOVERNMENT PRINTING OFFICE: 1935